

Foreign Policy In Focus



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Investment Funds

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Investment funds, established to provide capital for private enterprises and sponsored by government agencies and multinational institutions, are increasing in number every year. For example, the U.S. government offers funds through the U.S. Agency for International Development (AID) and the Overseas Private Investment Corporation (OPIC). Washington also provides capital to the International Finance Corporation (IFC), which, in turn, has established other funds.

Key Points

- Investment funds established by national governments and multinational institutions are increasing in number every year.
- The investment funds are intended to provide capital for investment in private firms in countries where private institutions are not providing enough money.
- The investment funds are generally managed by private companies but receive money or other assistance from a sponsoring government or multinational institution.

AID's enterprise funds, created in 1990, are supposed to promote development by identifying and implementing mechanisms for timely investment in the private sector of designated countries where private financial institutions are not providing adequate capital. Though the enterprise funds are private corporations (not U.S. government agencies) they receive money from AID to cover operating and administrative expenses. The funds make loan and equity investments intended to generate a financial return, benefit the investee, and have an overall positive impact on the host country.

AID now has nine funds, with total capital of \$1.27 billion, targeted toward investments in the following regions: Albania, Bulgaria, the Czech and Slovak Republics, Hungary, Poland, Romania, Central Asia, the western New Independent States (NIS), and Russia. The funds' investment approaches vary, depending on the economic conditions and business opportunities in the countries. For example, the Polish American Enterprise Fund invests primarily in established businesses, especially in the banking and finance sector. It holds majority equity positions and exerts management control in the businesses in which it invests and has been involved in few joint ventures with private foreign investors. In contrast, the Hungarian American Enterprise Fund has a large number of joint ventures with foreign (primarily U.S.) investors; the Czech and Slovak American Enterprise Fund invests more often in

start-up companies and generally seeks minority equity positions, leaving management of day-to-day operations to the entrepreneurs; and the Bulgarian American Enterprise Fund focuses on the agribusiness sector.

OPIC established its first investment fund in 1987; by 1996, the funds had ballooned to \$3 billion. OPIC currently sponsors 24 direct investment funds designed to make equity capital available for investments in eligible emerging markets where adequate private money is unavailable. Each fund is privately owned and managed and makes its own investment decisions based on expected risks and returns. OPIC guarantees a maximum of \$2 in long-term loans to the funds for every \$1 of private investment generated.

All but four of OPIC's funds target specific areas of the world, for example, the Africa Growth Fund and the Asia Pacific Growth Fund. The other funds are sector-specific and operate worldwide; three concentrate on environmental projects and one on investments involving U.S.-based small businesses. Typically, the funds acquire 5-40% of the equity capital of each of their portfolio companies.

The IFC, a member of the World Bank Group, approved its first fund in 1984. At that time IFC funds focused on preventing foreign control of a country's domestic firms and reducing the outflow of capital. Now the IFC concentrates on securing new sources of capital and on helping to improve the quality of financial markets. The IFC currently has financial commitments of \$806 million in 34 portfolio investment funds, 15 private equity funds, 53 venture capital funds, four unit trusts, and 37 fund management companies. Some are country-specific, such as the Peru Privatization Fund; others are regional, such as the Asian Infrastructure Fund Management Company; yet others are global, such as the Global Power Investments Company. OPIC's Israel Growth Fund is the largest single source of capital there. In the future, the IFC plans to increase the number of equity funds, develop debt funds that can invest in private corporate debt, and expand vehicles such as pension funds to mobilize savings.

The growth of investment funds is symptomatic of a broader shift away from government-to-government foreign assistance in favor of an emphasis on market forces, dating back to the Reagan administration's Private Enterprise Initiative. Proponents claimed that increased reliance on private enterprise and market forces, individual initiative and entrepreneurship, and the encouragement of competition to guide economic progress was essential to achieve sustained, equitable growth. Yet a 1985 congressional review identified a number of concerns. In particular, critics argued that the Initiative was indirect and would only benefit the poor through the "trickle down" of wealth. Regardless, the U.S. government continues to privatize foreign aid, in part by supporting investment funds.

U.S. economic and humanitarian assistance abroad constitutes less than 0.5% of the federal budget and only 0.117% of the gross domestic product—lower than any major industrialized nation. Despite these dismal statistics, "the idea behind the funds is to replace foreign aid," according to Mildred Callear, OPIC's acting president. Replacing aid that helps meet the basic needs of the poorest people in developing countries and newly independent states with funds directed at entrepreneurs puts decisions in the hands of narrow private interests, creates secrecy in the "foreign aid" process, and adds to the corruption of the relationship between governments and businesses.

Government legislation, operating procedures, and the minority financial interests held by government agencies combine to limit the input of national and multinational businesses regarding investment decisions of the development funds. The IFC provides an average of only 16% of its funds' initial capital, which potentially limits its input into those funds' decisions in comparison to the input from investors with larger shares of ownership. In contrast, AID has long had a reputation for micromanaging its development projects, despite a 1991 Senate Appropriations Committee report advising that "AID's role [in the enterprise funds] is simply to write the check on a periodic basis when the enterprise funds determine that additional funding is necessary." A House and Senate conference report also stipulated that "AID is not to attempt to second-guess investment decisions." Both reports called for a hands-off policy regarding oversight of enterprise funds by the executive branch. OPIC's *Program Handbook* similarly emphasizes that investment funds must make their own "commercially based investment decisions."

Managers can take advantage of national securities laws to maintain a shroud of secrecy around both the investors in and the investments of a fund. Although U.S. regulations limit advertisement of privately placed funds, they also exempt such funds from public disclosure requirements. Establishing a fund as a limited partnership allows its managers to limit distribution of annual reports to investors only. Thus taxpayers, who provide the ultimate financial backing for funds, cannot determine whether the investments are consistent with the purposes of foreign aid. A recent survey of Washington, DC-based OPIC investment funds by the

Corporate Wealthfare Project found that none of the funds would divulge the names of their investors or identify their investments.

Decisions by governments about sponsoring funds may hinge on political influence rather than on business or foreign aid goals. The firm of Steven Green, a Clinton friend and campaign supporter, is the primary investor in and manager of CEENIS, a fund that received \$160 million in financing from OPIC in 1995. Senator Richard Lugar's son is the contact person for the South America Private Equity Growth Fund, which received \$100 million in OPIC financing in 1995.

The funds can be used to dole out welfare to wealthy fund players, including managers, investees, and investors. BV Capital, for example, collected over \$3 million from OPIC's Agribusiness Partners International Fund in payment for identifying investors. Apax-Leumi Inc., the general partner of OPIC's Israel Growth Fund, collects an annual investment advisory fee of 2.5% of the fund's gross proceeds; the first installment totaled \$1 million. EurAmerica, an investee of AID's Hungarian American Enterprise Fund, paid its chief executive officer a first-year guaranteed \$400,000 salary and its president, \$300,000—both well above the salary guidelines of AID, the State Department, and the House Appropriations Committee.

Often fund investors can not only collect fat profits, but also manipulate investments to help their bottom lines. Returns on most IFC funds average 24% annually. One of OPIC's African funds generated a \$9.50 return on every \$1 invested, and projects financed by an OPIC Russian fund are expected to provide returns in the 30-50% range. Besides reaping big returns, large corporate investors may encourage funds to provide capital to their affiliated companies in developing countries. For example, investors in OPIC's Africa Growth Fund include Citibank, Coca-Cola, and Lumis, a cotton equipment firm with markets in Africa. The fund's early investments included a new merchant bank in Ghana and a bottling plant in Kenya. Not only does OPIC provide financing for funds, but most investments are backed by OPIC insurance. According to former OPIC President Ruth Harkin, "If you're an investor in an OPIC-supported fund, the worst you can do is get your money back in 10 years."

These funds may be the largest investors in a country and may dominate the local capital markets. More than 60% of the investors in IFC funds are foreign, not local, creating the potential for capital flight when earnings are distributed. With limited capital, funds must select investments, creating winning and losing companies and sectors in countries. AID's fund in Poland, for instance, has focused on established businesses, to the detriment of start-up companies.

<h3>Key Problems</h3> <ul style="list-style-type: none">• When investment fund capital replaces foreign aid to a country, programs intended to benefit the neediest people are slighted.• Privatizing foreign aid puts spending decisions in the hands of entrepreneurs, creates secrecy in the aid process, and increases the potential for corruption.• Foreign investment funds may harm host countries by dominating their capital markets, picking business winners and losers, and facilitating capital flight.

Investment funds should not substitute for foreign aid. If governments and institutions continue to support these funds, restrictions should apply.

End U.S. Government Involvement in Investment Funds

The U.S. government should end all its involvement in national and multinational investment funds. Appropriations should go to development programs

providing nutrition, housing, health care, and education directly to needy individuals overseas rather than into the coffers of entrepreneurs. Doling out welfare to fund managers, investors, and investees (including large multinational corporations), makes a mockery of recent U.S. cuts in domestic payments to poor, powerless people.

The stock markets of the world list numerous private international funds that could provide capital to viable local ventures. The U.S. firm, Fidelity Investments, for example, offers investors an Emerging Markets Fund, a Southeast Asia Fund, and a Latin America Fund. Some government-

tal fund investees have even obtained money from equity markets. Such financial access raises the questions of why these companies needed subsidized capital from the United States, and why, for example, the portfolio of AID's Hungarian fund included investments in two large, publicly traded companies.

Continued U.S. Government Involvement in Investment Funds Should Be Subject to Restrictions

If the U.S. government continues to sponsor investment funds, it should not provide loans or loan guarantees for the funds or insurance for the investments. Currently, as much as two-thirds of the capital of OPIC funds can come from loans guaranteed by the agency, while investments by the funds are also backed by OPIC insurance. Private lenders, including international consortia, already provide loans for viable projects all over the world, and a 1995 report prepared for the U.S.

Congress identified a number of companies that offer insurance for foreign investments.

The U.S. government may be able to contribute expertise, developed for other uses, to privately financed and insured funds. Supplementing the IFC, the government could help assess the need for funds as well as their appropriate focus and size, determine the feasibility of obtaining investors, evaluate potential fund sponsors and managers, publish information about local regulations for establishing funds, and help advise and monitor the funds. Nonfinancial U.S. government involvement could assist private investment funds to augment, not replace, foreign aid, without putting taxpayer assets in jeopardy.

Despite its pitfalls, the trend is toward increased financial sponsorship of investment funds and private sector investments by governments and multinational institutions. The Inter-American Development Bank's Multilateral Investment Fund, to which the U.S. and Japan are the major donors, has established the Small Enterprise Investment Fund, which provides loans or assumes equity or quasi-equity positions in private sector initiatives. The Asian Development Bank has participated in establishing the Asian Finance and Investment Corporation, and the African Development Bank may soon create its own African Finance Corporation. The private sector accounts for almost all loans and investments made by the European Bank for Reconstruction and Development. Thus, a withdrawal from investment funds by the U.S. government would run counter to the global trend.

If the U.S. government and its citizens believe that investment funds are effective foreign aid tools whose benefits outweigh their costs, then all private and government players should be subject to codes of conduct that ensure that fund activities be free from political meddling and focus primarily on meeting foreign aid goals, rather than on private profit targets. Funds should be required to assist appropriate development plans of the investee country, providing infrastructure to meet local needs rather than simply facilitating international business and trade. Furthermore, investment funds should be publicly accountable. Because taxpayers provide the ultimate backing for these funds, the names of fund investors and investments by the funds should be readily available public information.

Key Recommendations

- The U.S. government should end its involvement in investment funds and instead provide appropriations to programs that directly benefit disadvantaged people.
- The U.S. government may provide guidance to private investment funds so that they could be used to augment foreign aid.
- If the U.S. government continues to assist investment funds, the fund activities should be required to focus primarily on fostering equitable and sustainable development overseas and only secondarily on private profit targets.

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